Internal Revenue Service
memorandum

TL-N-1167-90
Br2:RTBailey

date: FEB 2 1990

to: District Counsel, Chicago CC:CHI
Attn: Robert A. Bedore

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]

This is in reference to your request for Tax Litigation Advice dated November 13, 1989, concerning the petitioner captioned above.

ISSUE

Whether the method used by petitioner, an accrual method taxpayer, to account for payments of unstated interest pursuant to I.R.C. § 483, prior to its amendment by the Tax Reform Act of 1984, is subject to the "clear reflection of income" standard set forth in section 446(b) under the facts described below.

CONCLUSION

A payment of unstated interest, determined under Old Section 483 and the underlying regulations, is allowable as an interest deduction solely under the provisions of section 163. Any deduction of interest under section 163 is subject to various limitations on the deduction of interest as well as the "clear reflection of income" standard of section 446(b). This statutory framework is reflected in the section 483 regulations.

Because the allocation of a disproportionate share of unstated interest to the payment made under the First Recourse Note reflects an amount far in excess of the amount of interest that would economically accrue under standard accounting rules, reporting an interest deduction in accordance with such allocation would result in a material distortion of income. Accordingly, respondent may use his power set forth in section 446(b) to limit petitioner's [redacted] interest deduction to the amount of interest that would economically accrue over the term of the First Recourse Note.

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FACTS

On [redacted], petitioner, [redacted], filed a Motion for Partial Summary Judgment, alleging that the Service erred in determining that a portion of its deduction for interest computed under section 483, prior to the 1984 amendments (Old Section 483), was not allowable because the interest deduction should have been limited by section 446(b). The Service filed a Preliminary Notice of Objection to Petitioner's Partial Motion for Summary Judgment in response. After submission of your request for advice, Judge [redacted] decided that this case should be continued pending a ruling by the Court in Williams v. Commissioner, Docket No. 36698-87, in which cross motions for partial summary judgment have been filed by the parties involving this identical issue with respect to a cash method taxpayer. Because Williams considers a cash method taxpayer and, if decided in favor of respondent, may be decided on very narrow grounds, we view your request as an opportunity to develop an argument with regard to accrual method taxpayers.

[redacted] is a limited partnership under the laws of the state of Illinois. Petitioner uses the accrual method of accounting for federal income tax purposes.

On [redacted], petitioner entered into an Agreement of Sale (the "Sale Agreement") with [redacted] ("[redacted]") for the purchase of [redacted]'s corporate headquarters. In petitioner's view, the fair market value of the corporate headquarters at and around the date of sale, as evidenced by the face value of the [redacted] title commitment required pursuant to the applicable terms of the Sale Agreement, and the appraisals obtained by [redacted] and petitioner in conjunction with the subject transaction, was approximately $[redacted]. The contract sales price, however, was $[redacted], which consisted of $[redacted] in cash, and a noninterest bearing recourse promissory note in the face amount of $[redacted] (hereinafter referred to as the "Purchase Note"), secured by a mortgage on the property and an assignment of leases and rents. The Purchase Note, by its terms, was payable in two installments. The first installment was due on [redacted] (approximately [redacted] months from the date the Sale Agreement was executed) in the amount of $[redacted] and the second installment was due on [redacted] ([redacted] years from the date the Sale Agreement was executed) in the amount of $[redacted].

On [redacted], the Purchase Note was divided into two separate noninterest bearing notes whose due dates and amounts matched the installment payments due under the Purchase Note.

One note (the "First Recourse Note) was in the face amount of $[redacted] and payable on [redacted] (later extended to [redacted]), and the second note (the "Second Recourse Note") was in the face amount of $[redacted] and payable on [redacted].

On or about [redacted], petitioner paid off the First Recourse Note. Because the First and Second Recourse Notes provided no stated interest rate, petitioner computed the amount of total unstated interest that existed therein in accordance with Old Section 483. This computation required a determination of the sum of the present values, using the factors prescribed by the section 483 regulations, as of the date of the Sale Agreement, of the payments to be made under the First and Second Recourse Notes. Section 483(b)(2). This resulting sum was then subtracted from the total payments due under the First and Second Recourse Notes to determine the total unstated interest amount. After determining the amount of the total unstated interest, petitioner allocated a portion of such interest to the [redacted] payment made on the First Recourse Note on a pro rata basis in accordance with the language of Old Section 483(a)(1) and Treas. Reg. § 1.483-1(a)(1). On its U.S. Partnership Return of Income, Form 1065, for the [redacted] tax year, petitioner included a deduction for unstated interest expense on the [redacted] corporate headquarters transaction described above in the amount of $[redacted]. According to our calculations, only approximately $[redacted] of interest economically accrued during the period covered by the First Recourse Note.

The Commissioner disallowed the allocation provided in Old Section 483 on the grounds that petitioner's income was not clearly reflected. The Commissioner asserts that petitioner must report the unstated interest element of the First Recourse Note in accordance with the economic accrual method.

ANALYSIS

In the discussion that follows, we have attempted to develop an argument that applies to accrual method taxpayers assuming we have no guidance from Williams. As you know on September 15, 1989, Judge Clapp heard oral argument on similar cross motions for partial summary judgment in Williams. Williams involves a similar attempt by the Commissioner to apply section 446(b) to an Old Section 483 transaction, but Williams involves a cash method taxpayer and the related issues under section 461(g) regarding the deductibility of prepaid interest by a cash method taxpayer. Depending on the court's analysis, the opinion in the Williams case may turn solely on section 461(g) grounds and may therefore be distinguishable from the issue presented in this motion.

We note, however, that if Williams is decided in the government's favor on the ground that the Commissioner may require a change in a method of accounting for interest expense in order to clearly reflect the taxpayer's income pursuant to section 446(b), then such conclusion will be equally applicable to this petitioner and other accrual method taxpayers utilizing the identical scheme. We also believe that if Williams is decided in the government's favor on the ground that the subversion of the Old Section 483 allocation rules results in an acceleration of interest expense in violation of the provisions of section 461(g), then such conclusion would go a long way in resolving the issue with regard to accrual method taxpayers notwithstanding the fact that section 461(g) applies only to cash method taxpayers. This is so because section 461(g) sets forth the general rule that a cash method taxpayer is to treat prepaid interest in the same manner as an accrual method taxpayer, i.e., the cash method taxpayer is allowed a deduction in the year during which interest represents a charge for the use or forbearance of money. Huntsman v. Commissioner, 91 T.C. 917 (1988), appeal filed, No. 89-1672 (8th Cir. April 18, 1989). See, also, Fox v. Commissioner, T.C. Memo. 1989-232. It would follow that if section 461(g) is a limitation on the deduction of unstated interest by a cash method taxpayer, then the economic accrual rule is a similar limitation on the deduction of unstated interest by an accrual method taxpayer.

We also wish to note that if the government should lose Williams, we would not recommend proceeding with this argument in this or any other case until we have had an opportunity to consider the impact of the opinion and the possibility of a government appeal.

Simply stated, our position in the instant case is that the deduction for unstated interest allocated to the First Recourse Note is not allowable to the extent such deduction exceeds the amount of interest that economically accrued over the term of the note. Although Old Section 483 calculates the amount of total unstated interest and allocates the interest on a pro rata basis, all transactions subject to Old Section 483 are also subject to the "clear reflection of income" standard set forth in section 446(b) and implied in section 461(a). Because the allocation of $[redacted] of the total unstated interest to the first payment reflects an amount far in excess of the approxmiately $[redacted] of interest that has economically accrued under standard accounting rules, reporting an interest deduction in accordance with such allocation would result in a material distortion of income. Support for this position becomes manifest after an examination of a few of the fundamental rules governing interest deductions.

The sole authority specifically allowing deductions for interest expense is found in section 163(a) which provides that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness. Regardless of whether interest payments are so delineated by the parties to a purchase and sale transaction or are imputed by Old Section 483, the statutory provision that enables the deduction is section 163(a). 6 Mertens Law of Federal Income Taxation §§ 26.01, 26.26; Conclusion 10 of Rev. Rul. 72-408, 1972-2 C.B. 86. See also Treas. Reg. § 1.163-1(a) which indicates that unstated interest is deductible under section 163 while referring the reader to Old Section 483 for computational rules. This axiom is also recognized by the section 483 regulations which provide, generally, that a contract under which there is total unstated interest shall be treated as if such interest were actually provided for in the contract, and such unstated interest shall constitute interest for all purposes of the Internal Revenue Code. Treas. Reg. § 1.483-2(a)(1)(i). "Any amount treated as interest under section 483 by the purchaser shall (if otherwise allowable) be deducted as interest. . ." Treas. Reg § 1.483-2(a)(1)(ii).

It is equally axiomatic that all interest deductions authorized by section 163(a) are subject to the "clear reflection of income standard" set forth in section 446(b). Ferrill v. Commissioner, 684 F.2d 261 (3rd Cir. 1982). Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. The "clear reflection of income" standard may also be inferred from section 461(a) which allows deductions for the tax year that is proper under the method of accounting used in computing taxable income. The legislative history of section 461(a) demonstrates that a deduction for an item of expense in the year paid or accrued must clearly reflect income. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. A161 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 305 (1954).

The "clear reflection of income" standard and the Commissioner's power to change a taxpayer's method of accounting where such method does not clearly reflect income is recognized in the regulations underlying section 446. Treas. Reg. § 1.446-1(a)(2) provides that it is recognized that no uniform method of accounting can be prescribed for all taxpayers. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. Treas.

Reg. § 1.446-4(b) provides that if a taxpayer does not regularly employ a method of accounting that clearly reflects his income, the computation of taxable income shall be made in a manner that, in the opinion of the Commissioner, does clearly reflect income. The Commissioner's power even extends to an otherwise permissible method of accounting used by a taxpayer to materially distort income. Treas. Reg. § 1.446-1(a)(2).

The above authorities vest the Commissioner with wide discretion in determining whether a method of accounting should be disallowed as not clearly reflective of income. Case law confirms this assertion. In interpreting section 446 and its predecessors, the Supreme Court reasoned that "[t]he Commissioner has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income". Commissioner v. Hansen, 360 U.S. 446, 467 (1959). "Since the Commissioner has '[m]uch latitude for discretion,' his interpretation of the statute's clear reflection standard 'should not be interfered with unless clearly unlawful.'" Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532-533 (1979), quoting Lucas v. American Code Co., 280 U.S. 445, 449 (1930).

The Commissioner's section 446(b) power extends not only to a taxpayer's overall method of accounting but also the accounting treatment of any item. Treas. Reg. § 1.446-1(a)(1). In this regard, the Commissioner's discretion under section 446(b) to require a change in the method of accounting for interest has been upheld on numerous occasions. Cole v. Commissioner, 64 T.C. 1091, 1106 (1975), aff'd, 586 F.2d 747 (9th Cir. 1978), cert. denied, 441 U.S. 924 (1979) (change required from cash to accrual); Sandor v. Commissioner, 62 T.C. 469 (1974), aff'd per curiam, 536 F.2d 874 (9th Cir. 1976) (change required from cash to accrual); Prabel v. Commissioner, 91 T.C. 1101, 1113 (1988), aff'd, 882 F.2d 820 (3rd Cir. 1989) (change required in accrual method); Planet Line, Inc. v. Commissioner, 89 F.2d 16, 17 (2d Cir. 1937), aff'g 34 B.T.A. 253 (1936) (change required in accrual method); James Brothers Coal Co. v. Commissioner, 41 T.C. 917, 924 (1964) (change required in accrual method). Interest imputed under the computational methodology of Old Section 483 is, likewise, subject to the "clear reflection of income" standard of section 446(b) because such interest is deductible only under section 163(a).

Requiring a change in a method of accounting for interest to the economic accrual method when the taxpayer's current method does not clearly reflect income is a reasonable exercise of the Commissioner's section 446(b) power. This conclusion is supported by the reasoning set forth in Rev. Rul. 83-84, 1983-1 C.B. 97. In Rev. Rul. 83-84, the Service announced certain fundamental principles regarding the deductibility of interest on indebtedness. Although the revenue ruling specifically addresses the proper method of accounting for interest on indebtedness when the terms of that indebtedness state that interest is earned in accordance with the Rule of 78's, the scope of the revenue ruling is not limited to situations in which the Rule of 78's is applied. The principles set forth in the revenue ruling provide guidance in dealing with the instant transaction.

The revenue ruling states initially that no method of accounting for interest is acceptable unless it clearly reflects income. The ruling further states a general principle:

> An agreement between a borrower and a lender with respect to any one year of a loan is not independent of the agreement with respect to any other year of the loan. In general, the substance of a loan agreement is that the same rate of interest applies to each taxable year of the loan, regardless of any contrary formulas that may be stated in the agreement.

According to the revenue ruling, the amount of interest attributable to the use of money for a period between payments is determined by applying the "effective rate of interest" on the loan to the "unpaid balance" of the loan. The effective rate of interest is a measure of the cost of credit, expressed as an annual rate, that relates to the amount and timing of values received to the amount of and timing of payments made, and is thus a reflection of the cost of the amount borrowed for the time it is actually available. Rev. Rul. 83-84, citing Conf. Rep. No. 760, 97th Cong., 2d Sess. 553 (1982); S. Rep. No. 494 (Vol. I), 97th Cong., 2d Sess. 209 (1982); Supplement I to Regulation Z issued by the Federal Reserve System, 12 CFR §§ 226.6., 226.40 (1979). The effective rate of interest, which is a uniform rate over the term of the loan, when applied to the unpaid balance of the indebtedness for a given period will, according to the revenue ruling, produce the time cost of that indebtedness for the period. This cost is referred to as the "economic accrual of interest" for such period.

The revenue ruling continues by broadly stating that because interest is earned by application of the effective rate of interest over the term of the loan, any agreement that provides that interest is earned in another manner lacks economic substance because it fails to reflect the true cost of borrowing. Regarding accrual method taxpayers, the revenue ruling concludes that no deduction will be allowed to the extent that the debtor's liability for payment is for interest that does not economically accrue in the current year. To the extent that such interest pertains to a subsequent period, it must be allocated to that period.

The conclusions reached in Rev. Rul. 83-84 generally reflect the sentiments of Congress as expressed in the committee reports underlying the enactment of section 461(g). This section essentially assures that prepayments of interest by a cash method taxpayer will be treated, for tax purposes, as if the taxpayer were on the accrual method of accounting. The Senate Report states that "[i]n determining whether an interest prepayment is properly allocable to one or more taxable years after the year of payment, the committee intends that the allocation be made to the period or periods in which the interest represents a cost of using the borrowed money in that period." S. Rep. No. 938, 94th Cong., 2d Sess. 104 (1976). See also H. Rep. No. 658, 94th Cong., 1st Sess. 100 (1975).

Rev. Rul. 83-84 has also been specifically upheld by the courts. For example, in Prabel v. Commissioner, 91 T.C. 1101 (1988), aff'd 882 F.2d 820 (3rd Cir. 1989), the taxpayers were cash basis limited partners in an accrual basis partnership that purchased real estate. The purchase was effected by a relatively small cash down payment and a nonrecourse note for the considerable balance. The note provided for the allocation between principal and interest in the event of prepayment by application of the Rule of 78's. Accordingly, the partnership accrued interest deductions under the Rule of 78's and the taxpayer's share of interest deductions was so computed. The Commissioner disallowed such deductions to the extent they exceeded the taxpayer's share of interest expense that would have economically accrued for 1981 and 1982, the tax years in issue.

Because any applicable Code section that would have required the partnership's accrual of interest expense in accordance with economic accrual principles was not introduced until 1984 (section 461(h)) and was not applicable to the years in issue, the question arose as to whether the Commissioner could compel a change in the partnership's method of accounting for interest expense to the economic accrual method. The Tax Court sustained the Commissioner's redetermination and specifically addressed his power, under section 446(b), to require the reporting of interest expense in accordance with economic accrual principles. The court noted:

> The use of the economic-accrual or actuarial method of accruing interest has been recognized for many years. For example, in 1967, the accounting industry endorsed economic-accrual principles of accounting for premiums and discounts on debt obligations over their terms. See Accounting Principles Board Opinion No. 12, (AICPA) (1967). In 1968, the Truth In Lending Act, 15 U.S.C. Sec. 1601 et. seq., 82 stat. 146, was enacted. That act required the disclosure of annual interest due on most consumer loans to be computed on the actuarial or economic-

> accrual method. 15 U.S.C. sec. 1606. See also discussion infra at 1121-1123. Having sustained respondent's rejection of [the partnership's] method of accruing interest, we also sustain respondent's determination that [the partnership] must accrue interest relating to the note using the economic-accrual method.

Prabel, 91 T.C. at 1120.

Rev. Rul. 83-84 and the required changes to economic accrual has also been upheld in Levy v. Commissioner, 92 T.C. 1360 (1989), and Mulholland v. United States, 16 Cl. Ct. 252 (1989), following the Prable reasoning. See also, Saller v. United States, 694 F. Supp. 224 (E.D. Tex. 1988) in which the efficacy of Rev. Rul. 83-84 was upheld without specific mention.

In the instant transaction, the interest deduction taken by petitioner in the tax year in which the first payment is made represents an amount far in excess of the approximately $[redacted] of interest that economically accrued by the time of the payment. Such a deduction would reflect a substantial acceleration of the interest due under both notes. Therefore, the Commissioner may invoke his power under section 446(b) and require petitioner to report its interest expense in accordance with the economic accrual of interest method.

Petitioner fashions several arguments in favor of applying the pro rata allocation formula of Old Section 483 to its abusive transaction. Foremost, petitioner argues that Old Section 483 is a specific provision that cannot be overridden by the more general provisions of section 446(b). In support of this argument, petitioner cites the canon of statutory construction.

We agree that where there is a conflict between statutory provisions, the specific will prevail over the general. Bulova Watch Co. v. United States, 365 U.S. 753 (1961). However, where no direct conflict exists it is appropriate to read Old Section 483 and other applicable statutory provisions in pari materia. See Katkin v. Commissioner, 570 F.2d 139 (1978), aff'g 67 T.C. 379 (1976), (No direct conflict between reorganization provisions and section 483). Compare, Fox v. United States, 510 F.2d 1330 (3d Cir. 1975) (Direct and inherent conflict between section 215, which dealt with the deductibility of alimony payments, and section 483). An examination of the purpose of Old Section 483 shows that it is not in direct conflict with section 446(b) and does not override such section, nor did Old Section 483 contemplate an abuse of the nature attempted by petitioner.

Section 483 was enacted as part of the Revenue Act of 1964. Its sole purpose was to prevent the reporting of interest income as capital gain when a taxpayer sold a capital asset on an installment basis without providing for interest payments or when the interest rate provided was inadequate. H.R. Rep. No. 748, 88th Cong., 1st Sess. (1963), reprinted at, 1964-1 (Part 2) C.B. 125, 196-198; S. Rep. No 830, 88th Cong., 2d Sess. (1964), reprinted at, 1964-1 (Part 2) C.B. 505, 605-608.

Under prior law, by increasing the total amount of the principal payments above the amount that would have been charged for immediate payment the seller would be adequately compensated for the absence of a stated interest rate but would be able to report all sales proceeds as capital gain. In order to close this loophole, the Kennedy Administration proposed that a portion of any deferred payment should be treated as interest, as long as, (1) the payment met certain objective criteria, (2) no specific exception was applicable, and (3) either too little or no stated interest had been provided for by the parties to a sales agreement. Solomon v. Commissioner, 570 F.2d 28, 33 (2d. Cir. 1977). In short, Old Section 483 sought to cure an abusive practice aimed at converting ordinary interest income into long term capital gain.

As is clear from its legislative history, and the face of the statute itself, Old Section 483 was only intended to recharacterize as interest a portion of the sales price that the parties to the transaction delineated as principal. There is nothing in the legislative history or the statute that would prevent the application of section 446(b) or any specific section that would otherwise limit the deduction of interest. It is clear that the framers of Old Section 483 never envisioned the abusive scheme advocated by the taxpayer. Rather, we contend that the rules of Old Section 483 were enacted to place a transaction in which no or insufficient interest is stated on the same footing, for federal tax purposes, as a transaction in which interest at an appropriate rate is expressly provided. Therefore, it is clear that the purpose of Old Section 483 would be frustrated if the mere failure to state an adequate interest rate would permit the petitioner to avoid the limitations that would otherwise apply to a payment of stated interest.

Consistent with the intent of Old Section 483, the regulations specifically contemplate that various limitations on the deductibility of interest apply to amounts characterized as imputed interest. Treas. Reg. § 1.483-2(a)(1)(ii) provides that, "Any amount treated as interest under section 483 by the purchaser shall (if otherwise allowable) be deducted as interest for the taxable year in which the payment is made in the case of a cash method taxpayer..." The parenthetical language clearly indicates that some amounts will be treated as interest under section 483, but will not be deductible due to the applicability of statutory restrictions. Consistent with this view, the regulations state that amounts treated as interest may be nondeductible because of section 267 (transactions between related parties) and may be capitalized under section 266 (carrying charges) under certain circumstances. Treas. Reg. § 1.483-2(a)(2).

The statement in Treas. Reg. § 1.483-2(a)(2) concerning certain effects of treating payments as interest under Old Section 483 is expressly provided as nonexclusive. Additionally, the illustrations emphasize the view that a payment regarded as interest under Old Section 483 is treated in the same manner as a payment of interest otherwise delineated by the parties. Treas. Reg. § 1.483-2(a)(1)(i). Thus, for example, although not specifically mentioned, limitations contemplated by the regulations include section 265(2) (disallowing deductions for interest incurred to purchase or carry tax exempt obligations), and section 163(d), restricting the deductibility of investment interest. Thus, the limitations contemplated by the regulations must be read to include section 446(b). Any argument that the rules of section 483 operate in vacuo, without any limitation, is without support in law or logic.

In further support of the argument that section 446(b) cannot override a specific code provision, petitioner cites B. Bittker, Federal Taxation of Income Estates and Gifts para. 105.1.6 (1981), in which Professor Bittker states that the broad supervisory power vested in the Service by section 446(b) must be preempted by code sections that provide specific accounting rules. As an example, Professor Bittker discusses section 174 which allows a current deduction for research and experimental expenditures even though income may be more clearly reflected by requiring capitalization and depreciation of such outlays. Petitioner also cites a myriad of other code sections that prescribe specific tax accounting rules (e.g., section 456) and seek to draw an analogy to section 483.

Although this argument appears to be compelling at first blush, we believe that an examination of the statutory provisions reveals that petitioner is once again attempting to confuse the issue and legitimize an abusive transaction.

Section 446(c) provides that subject to the provisions of sections 446(a) and 446(b), a taxpayer may compute taxable income under any of the following methods of accounting. The prescribed methods include, "any other method permitted by this chapter," which, of course, would include section 483 and the other Code sections cited by the petitioner. Section 446(c)(3). Thus section 446(c) specifically makes all statutorily prescribed tax accounting methods subject to the "clear reflection of income" standard. See also Treas. Reg. § 1.446-1(a)(2) which extends the Commissioner's power to otherwise permissible methods of accounting that are used to materially distort income.

Of course, this does not mean that the Commissioner can force a taxpayer off a statutorily prescribed method when the taxpayer is entitled to use such method and is, in fact using such method in a manner intended by Congress. This point is illustrated by the excerpt from Professor Bittker's work, where a taxpayer is legitimately deducting research and experimental expenditures in a manner prescribed by section 174, and has long been recognized by the Office of Chief Counsel. See, e.g., [redacted], G.C.M. 37083, I-95-77 (April 11, 1977), in which Counsel concluded that," because the double declining balance method of depreciation is expressly described as providing a 'reasonable allowance' for depreciation in Code § 167(b)(2), we believe the Commissioner is precluded from invoking his section 446(b) discretion to deny the use of this method...."

However, this does not preclude the Commissioner from exercising his section 446(b) power in instances in which a statutorily prescribed tax accounting method is being abused. Any other conclusion would render meaningless the language of section 446(c). To illustrate this point, an analogy may be drawn to Auburn Packing Co., Inc. v. Commissioner, 60 T.C. 794 (1973), acq. in result only on this issue, 1974-2 C.B. 1, and Counsel's response thereto in Auburn Packing Co., Inc. v. Commissioner, A.O.D. (Feb. 6, 1974). In Auburn Packing, respondent argued that irrespective of whether the taxpayer met all of the requirements for use of the unit-livestock-price method, a method specifically permitted by Treas. Reg. § 1.471-2(b), respondent could require the taxpayer to use an inventory method that clearly reflected income. The court eschewed this argument and concluded that, because the taxpayer had complied with all of the requirements of the regulations and because the method had been consistently used, respondent could not require the taxpayer to change.

The A.O.D., however, states, "The Service does not agree with the Court's statement that the Service may never prevent use of an inventory method which is provided for by regulations." The A.O.D. also indicates that when the use of a prescribed method results in a substantial distortion of income that was not intended by the drafters, the Commissioner may require a change. See also [redacted], O.M. 17971, I-4145 (Dec. 18, 1973), which states, "... we do not agree that the Commissioner is unable, as a matter of law, to assert a clear reflection argument when taxpayer has employed a method authorized by the regulations.... Accordingly, we recommend that any Action on Decision in the instant case be conditioned to indicate our view that the Code § 446(b) mandate of clear reflection is an applicable argument even when a taxpayer employs a method authorized by regulations."

Our position regarding the scope of section 446(b) is further supported by the regulations underlying section 456. As you know, section 456 is one of the specific code sections cited by petitioner as an example of where the line must be drawn on the Commissioner's section 446(b) power. Yet, Treas. Reg. § 1.456-2(e) specifically applies "clear reflection of income" standards to the section 456 election when used in conjunction with the cash method of accounting. If petitioner's assertion were true, application of this regulation section would result in abuse of discretion. However, we are aware of no case that invalidates Treas. Reg. § 1.456-2(e).

It should also be noted that the argument of petitioner that respondent's theory regarding the scope of section 446(b), if applied to specific Code sections such as section 456, would render such sections as nullities is a non sequitur. Respondent's litigation position prior to the enactment of section 456, which is made so much of by petitioner, is irrelevant. Section 456 specifically directs the taxable year of inclusion and was enacted as a benefit to taxpayers in order to prevent the "bunching" of income in the taxable year of receipt. H.R. Rept. No. 381, 87th Cong., 1st Sess. (1961), reprinted at, 1961-2 C.B. 390, 391. It would be inappropriate to apply section 446(b) principles in such circumstances because the rules of section 456 are specific and operate to prevent a distortion of income in Congress' view. This should be contrasted with the instant situation in which the allocation rules of a statutory provision enacted solely to recharacterize as interest a portion of what is otherwise delineated as principal are subverted in order to achieve an accelerated interest deduction.

Petitioner next argues that the pro rata allocation employed in the instant case is specifically authorized by legislative history, statute and regulations. As discussed earlier, the Old Section 483 regulations are broadly drafted and clearly contemplate that restrictions on the deductibility of interest apply to amounts characterized as unstated interest. See the parenthetical (if otherwise allowable) language of Treas. Reg. § 1.483-2(a)(1)(ii). See also Treas. Reg. § 1.483-2(a)(2). It is, therefore, not unreasonable to conclude that such regulations are broad enough to include section 446(b) as a limitation. Thus, petitioner's argument must fail for this reason alone.

Moreover, the pro rata allocation formula described in legislative history contemplated loans the repayment schedules of which were within the scope of reasonable business practice and did not foresee abuses of the type employed by petitioner. See H.R. Rep. No. 749, 88th Cong., 1st Sess. (1963), reprinted at, 1964-1 (Part 2) C.B. 125, 333, which described an example in which the repayment schedule is $2,000 per year over three years with payments due annually. The pro rata allocation formula set forth in the regulations likewise contemplates repayment schedules that are within the scope of reasonable business transactions. The example set forth in Treas. Reg. § 1.483-2(a)(1)(iii) provides an explanation of the pro rata allocation rule properly applied in a manner consistent with the statute. Payments in this example are uniform and due annually. The facts of this example are clearly different from petitioner's payment schedule.

It should be noted that there is nothing inherently incorrect in a pro rata or straight line allocation of interest as is illustrated in James Brother's Coal Co. v. Commissioner, 41 T.C. 917 (1964). We believe that it was the James Brother's scenario that Congress was attempting to replicate in enacting Old Section 483. However, we contend that in order for the pro rata formula to correctly approximate interest accruals, the payments must be relatively even in amount and due at least annually.[1]

In Point IV of petitioner's supporting memorandum, an argument is made that appears to indicate that the 1984 amendments of section 483 somehow retroactively bless this transaction. Nothing could be further from the truth. Section 483 was amended in 1984 because of the inadequacy of its interest rates. The safe harbor and imputed interest rates provided in section 483 prior to the amendment did not represent economic rates of interest because: (1) The rates had not kept pace with market interest rates, (2) the simple interest computation used in testing the adequacy of stated interest ignored the compounding or interest on unpaid interest and, (3) the use of a single rate for all obligations, regardless of the length of time before maturity failed to reflect the fact that lenders typically demanded different returns on investment depending upon the term

[1] We believe this argument can also be used to refute petitioner's Point V. Reliance on the original issue discount provisions prior to the TEFRA amendments does not help petitioner's argument because, prior to 1982, section 1232 allocated OID pro rata on a monthly basis. Thus, no analogy can be drawn to petitioner's 30 year term/2 payment scheme.

of the loan. H.R. Rept. No. 432 Part 2, 98th Cong., 2d Sess. 1245 (1984). With regard to transactions of the instant type, Congress made a very revealing comment:

> The committee also understands that some shelters are exploiting section 483's method of allocating unstated interest among deferred payments to accelerate several years' interest charges into the year of the sale. To illustrate the potential for abuse, assume property with an established fair market value of $100,000 is sold for 2,500 in cash and two negotiable notes, one maturing six months and one day after the sale (payments on an obligation are within the scope of section 483 only if they are due more than 6 months after sale), the other 30 years after the sale. The present value of the cash and notes, assuming a 12 percent interest rate, would approximately equal the $100,000 value of the property. Since the notes have no stated interest, section 483 imputes interest at a rate of 10 percent, compounded semi-annually. Applying this rate, the total unstated interest in the deferred purchase contract is $99,408-the $200,000 aggregate face value of the notes less $100,592, the sum of their present values.
>
> Since the deferred payments are made in two equal installments, the total unstated interest of $99,408 is allocated under section 483 one-half ($49,704) to the first note and one-half to the second. Thus, the purchaser in this example is arguably entitled to deduct as interest almost one-half the cost of the property in the year of purchase when economically, virtually all of the imputed interest is paid in the second payment although (sic) (<u>it is possible that the rules restricting deductions for prepaid interest may apply to limit the amount of the interest deduction in this situation</u>). Although the section 483 rules would otherwise require the seller to recognize the same $49,704 as ordinary income in the year of payment, the seller may be able to avoid this result by disposing of the first note with within 6 months of the sale (emphasis supplied).

H.R. Rept. No. 432 Part 2, <u>supra</u> at 1245 n.12.

The emphasized language[2] quoted above indicates that Congress intended that section 483, prior to the 1984 amendment, was to be read in conjunction with, at least, section 461(g). Because section 461(g) appears to be nothing more than a codification of "clear reflection" principles, this supports our position that the rules of section 446(b) likewise apply. See Cole v. Commissioner, 64 T.C. (1975), aff'd, 586 F.2d 747 (9th Cir. 1978), and Sandor v. Commissioner, 62 T.C. 469 (1974), aff'd per curiam, 536 F.2d 874 (1976), in which the courts applied section 446(b) to interest prepayments by cash method taxpayers; as indicated by the legislative history to section 461(g), such section was enacted to curb the abuses considered by the courts in those cases.

Petitioner argues further that use of the Commissioner's section 446(b) power to "override" Old Section 483 is an unwarranted attempt to apply the 1984 amendments retroactively. Apparently, petitioner believes that the economic accrual method was introduced in 1984 and does not apply to transactions covered by prior law. Such is simply not the case. As we have previously stated in this memorandum in our discussion of Prable, use of the economic accrual or actuarial method is a long-standing method of accounting for interest. In Prable, the taxpayer's partnership utilized the Rule of 78's with the result that interest expense was accelerated far beyond that which would have economically accrued in 1981 and 1982, the years at issue. The taxpayer contended that the Rule of 78's method was an acceptable method, widely used in reasonable commercial transactions and even sanctioned by the Commissioner in Rev. Rul. 72-100, 1972-1 C.B. 122, and Rev. Rul. 72-562, 1972-2 C.B. 231.[3] Likewise, in the instant case, the taxpayer is applying the allocation rules of section 483 in a distortive manner not contemplated by the statute and regulations to wildly accelerate interest expense far in excess of that which would have economically accrued over the same period. Like the taxpayer in

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2 Similar language is found in the Joint Committee Explanation of the 1984 Act. The related footnote provides in pertinent part:

> Although the rules restricting deductions for prepaid interest might apply to limit the amount of the interest deduction in this situation, the result is not clear.

> Joint Committee on Taxation, General Explanation Of The Revenue Provisions of the Deficit Reduction Act of 1984, 113 n. 17 (1984).

3 Both revenue rulings were modified and superseded by Rev. Rul. 83-84.

Prabel, who claimed reliance on reasonable commercial practice and published positions of the Internal Revenue Service, this taxpayer claims that the section 483 regulations permit accelerated interest deductions. We believe that the result in the instant case should be the same as that in Prabel. Any argument that the economic accrual method cannot be applied to cure distortions arising from manipulations of the pro rata allocation formula of section 483 must similarly fail.

We also note that petitioner, in Point II of his supporting memorandum, cites a National Office Technical Advice Memoranda (TAM) which purports to illustrate the Service's view of the interplay of sections 446(b) and 483. In response to this argument, three points should be made: First, section 6110(j)(3) provides, generally, that a written determination may not be used or cited as precedent.

Second, the TAM has nothing to do with the issue in this case. TAM 8641002, concerns a method of accounting for items of farm income and expense and whether such method may be overridden by section 446(b). The TAM concludes that section 464 controls in the instance considered and no objection could be raised under the "clear reflection of income" standard set forth in section 446(b). However, the purpose of section 464 is to curb abuses of the cash method and, in application, applies clear reflection of income principles to situations that occurred under prior law. S. Rep. No. 94-938, 94th Cong., 2d Sess. 51 (1976). In stark contrast, the purpose of section 483, as discussed above, was to prevent the reporting of income as capital gain where such income represented a charge for the use of money. Its purpose was not to override nor supplant the "clear reflection of income" standard.

Third, if petitioner wishes to cite technical advice memoranda, clearly ignoring the proscription set forth in section 6110(j)(3), then it should cite the technical advice memorandum that squarely addresses the issue, rather than confuse the issue. In TAM 8830002 a situation substantially similar to the case at bar was addressed except that it concerned a cash method taxpayer. The Service concluded in TAM 883002, after applying sections 446(b) and 461(g), that a portion of the taxpayer's [redacted] payment of unstated interest represented a charge for the use of money for periods after the close of the taxpayer's [redacted] tax year and was not deductible in [redacted]. Rather, such portion was chargeable to capital and treated as paid in the period to which it was properly allocable. TAM 883002 further concluded that the method of accounting used by taxpayers to account for the [redacted] payment of unstated interest did not clearly reflect the taxpayer's income and the Commissioner may prescribe an alternative method of accounting for such payment.

[4] We wish to clarify that we do not rely on TAM 8830002. Rather, it is discussed solely to illustrate petitioner's selective and misleading citation of purported authority.

As a final matter, we bring to your attention a point that was not made by petitioner but looms as a litigating hazard for the government. The regulations underlying Old Section 483 do not vary from the ordinary rules found in section 461 as to the timing of unstated interest deductions for cash method taxpayers. However, such regulations provide a significant adjustment in the timing of unstated interest deductions for accrual method taxpayers. Compare the "All Events" Test of Treas. Reg. § 1.461-1(a)(2) with the provisions of Treas. Reg. § 1.483-2(a)(1) which permit a deduction for unstated interest by an accrual method taxpayer only when payment is due. Thus, an accrual method taxpayer presents a much more difficult case, from the government's perspective, than a cash method taxpayer because it is easier for an accrual method taxpayer to illustrate that Old Section 483 contains specific accounting rules for the treatment of unstated interest that cannot be overridden by the more general provisions of section 446(b) and, generally, section 461.

Although this provision is unfortunate and does not appear to be in keeping with the purpose of Old Section 483, it is a limited alteration of accrual accounting rules and does not preempt the restrictions on the premature accrual of interest. Further, the postponement of a deduction (and income) provided by Treas. Reg. § 1.483-2(a)(1) may be justified on the ground that the deduction should not precede economic performance. In any event, we do not recommend discussing this point unless it becomes necessary in the context of a reply brief or at oral argument.

If you have any questions, please contact Randolph T. Bailey at FTS 566-3470 or Lewis J. Fernandez at FTS 566-3289.

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